

Revision to Commissioner's Directive on the Operation of Transfer Pricing

Twenty years have passed since Japan introduced its transfer pricing taxation system. On March 20, 2006, the National Tax Agency ("NTA") partly revised the Commissioner's Directive on the Operation of Transfer Pricing (issued on June 1, 2003) and the Commissioner's Directive on the Operation of Transfer Pricing for Consolidated Corporations (issued on April 28, 2005) (hereinafter collectively referred to as "the Directive"), which are administrative guidelines on operational procedures in transfer pricing taxation. The revision aims to explicitly provide specific rules for treating intangible property transactions and cost contribution arrangements ("CCAs") under Japanese tax legislation, given their increasing significance in cross-border transactions. The move is partly driven by the fact that the NTA is concerned by the current situation, caused by the transfer of manufacturing facilities overseas, or "hollowing out" of industry, whereby a number of Japanese corporations are not receiving sufficient and appropriate remuneration for the intangible assets and management services that they provide to their foreign subsidiaries. It should be noted that a new paragraph on intra-group services was already added to Commissioner's Directive on the Operation of Transfer Pricing on June 20, 2002, in relation to the management services mentioned above.

I. Major changes

Prior to the revision, the Directive included one provision, relating to intangible asset transactions, recognizing the economic ownership of intangible assets, at paragraph 2-11 (License for the use of intangible assets etc). This paragraph has been replaced and expanded to three paragraphs. In addition, the Directive introduced five paragraphs regarding the treatment of CCAs. These new paragraphs are listed below.

- 2-11 Intangible assets to be considered in examinations;
- 2-12 Contribution to the creation, maintenance or development of intangible assets;
- 2-13 Licensing transactions of intangible assets;
- 2-14 Cost contribution arrangement;
- 2-15 Treatment of CCAs;
- 2-16 Points to note when examining CCAs;
- 2-17 Use of pre-existing intangible assets in CCAs;

2-18 Documentation to be inspected when examining CCAs.

The new rules are essentially in line with the OECD's transfer pricing guidelines provided in Chapter VI "Special Considerations for Intangible Property" (released in April 1996) and Chapter VIII "Cost Contribution Arrangements" (released in September 1997) of *Transfer Pricing Guidelines For Multinational Enterprises And Tax Administrations* ("OECD Transfer Pricing Guidelines").

II. New provisions on intangible asset transactions

The definition of an "intangible asset" under the Japanese transfer pricing legislation can be found in Paragraph (2)-3 (8), Article 66-4, Chapter 12 of Commissioner's Directive on Interpretation of Special Taxation Measures Law (in relation to Corporation Tax Law) revised on September 8, 2000 ("Commissioner's Directive dated September 8, 2000"). That paragraph explains, by referring to Paragraph 20-1-21, Commissioner's Directive on Interpretation of the Corporation Tax Law, that intangible assets, in a transfer pricing context, refer to a rather broad concept encompassing not only legal rights, such as industrial property rights, but also know-how, manufacturing processes, and designs. The Directive is subordinate to the Commissioner's Directive dated September 8, 2000.

1. Intangible assets to be considered in examinations

Paragraph 2-11 of the revised Directive prescribes that examiners must take into account not only intangible assets associated with technological innovation, which has traditionally been considered to contribute to earning excess income, but also the following two types of intangible assets:

- * Intangible assets associated with human resources
- * Intangible assets associated with systems

As a result, it is believed that, for example, the scope of "material intangible assets" that should be taken into account in applying the residual profit split method prescribed in Paragraph (4)-5, Commissioner's Directive dated September 8, 2000 has been broadened.

2. Contribution to the creation, maintenance or development of intangible assets

The old Directive provided in Paragraph 2-11 (License for the use of intangible assets) that examiners must consider not only the legal ownership of the intangible asset but also the contribution to the creation, maintenance and development of that asset. The new Directive prescribes that, in order to evaluate such contributions, it is necessary to comprehensively examine functions performed in:

- * Making decisions
- * Rendering services
- * Bearing costs
- * Managing risks

3. Licensing transactions of intangible assets

Foreign-related transactions relating to the use of intangible assets can take the form of either an asset transfer or a license. Under the new Directive, unless the intangible asset is considered to have been transferred from one party to the other party, examiners are required to calculate an arm's length price for the licensing transaction, even where there is no arrangement for the use of that property between the parties. The new Directive also prescribes how to appropriately determine the date on which the licensing transaction commenced.

III. New provisions on CCAs

Given the lack of transfer pricing regulations for CCAs in Japan, many readers may be unfamiliar with this type of arrangement. In the West, however, CCAs are a form of agreement that is frequently entered into by enterprises. Paragraph 8.3 of the OECD Transfer Pricing Guidelines defines a CCA as follows: "A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights."

1. CCAs and their treatment

The new Directive defines CCAs in terms of the following two aspects, which are associated with activities such as research and development ("R&D").

- * Cost sharing – based on proportionate shares of expected benefits

* Acquisition of an interest in results – based on proportionate shares of costs incurred

If the costs borne by a participant of a CCA exceed the arm's length price, the costs corresponding to the excess portion are deemed not to be arm's length, and will not be included in that corporation's deductible expenses.

2. Points to note when examining a CCA

The new Directive lists seven items that should be examined when evaluating the appropriateness of the level of costs borne by a corporation.

- (1) Scope of R&D activities;
- (2) Whether or not proportionate shares of expected benefits are appropriately estimated in order to determine costs to be borne by each participant;
- (3) Whether or not participants in the CCA directly receive the resultant benefits;
- (4) Whether or not a reasonable basis (such as sales, gross profit, operating profit, number of units manufactured or sold) is used for computing expected benefits;
- (5) Whether or not proportionate shares of expected benefits are verified;
- (6) Cases in which there is a significant difference between each participant's proportionate share of expected benefits and that of realized benefits, whether or not such difference is analyzed
- (7) In the event of "buy-in" or "buy-out", whether or not the intangible asset already created by the CCA is evaluated and appropriate payment for interests in such intangible asset is made between the entrant/withdrawer and the existing/remaining participants

3. Use of pre-existing intangible assets in CCAs

According to the new Directive, where a participant's pre-existing intangible asset (meaning an intangible asset other than those acquired and/or developed through the CCA), is used for the purpose of the CCA, but is not transferred to the rest of the participants, it is necessary to include in costs to be borne by the owner the amount equivalent to the royalty that would have been paid for the pre-existing intangible asset.

4. Documentation to be inspected when examining CCAs

In addition to the documents listed in Paragraph 2-4 (Documents to be inspected at the time of

examination) of the Directive, the added paragraph states that examiners are required to analyze not only the written CCA agreement, but also seven types of document produced prior to concluding the CCA, four types of document produced after concluding the CCA, and two other types of document.

IV. Conclusion

The NTA has established three directives concerning the transfer pricing legislation, i.e. Commissioner's Directive amended on September 8, 2000 (on interpretation of Special Taxation Measures Law) and Commissioner's Directive amended on June 8, 2005 (on mutual agreement procedures) as well as the amended Directive (on operation of transfer pricing), in its efforts to enforce transfer pricing regulations in an appropriate and efficient manner. The NTA has been trying to clarify tax treatment in areas lacking sufficient rules in the existing regulations by amending these directives as necessary, so as to secure transparency and consistency in transfer pricing administrative procedures. Given that various transfer pricing issues are being addressed by the Committee of Fiscal Affairs of the OECD and others in an international context, it is expected that the NTA will continue to work on a number of improvements to relevant directives.

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For further information, please contact Yasuko Takahashi or Mayumi Nakamura at:

E-mail: pwjapan.taxpr@jp.pwc.com Tel:03-5251-2400